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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

ESTATE OF A. GOURIELLI, Deceased, THE HANOVER BANK, Executor, and HELENA GOURIELLI, Surviving Wife,

Petitioners,

—v—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

JACOB A. and BERTHA L. GOLDFARB,

Petitioners,

—v—

COMMISSIONER OF INTERNAL REVENUE.

Respondent.

JOINT PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

HORACE S. MANGES
Attorney for Petitioners
in *Gourielli* and *Goldfarb*
60 East 42nd Street
New York City

Of Counsel
SQUADRON, ALTER & WEINRIB
WEIL, GOTSHAL & MANGES

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Respondent.

JOINT PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

THE HANOVER BANK, Executor, and HELENA GOURIELLI, Surviving Wife, and JACOB A. and BERTHA L. GOLDFARB, pray that a Writ of Certiorari issue to review the judgments of the United States Court of Appeals for the Second Circuit, entered in the above entitled cases on April [illegible], 1961.

Citations to Opinions Below

The Opinion of the Tax Court in the *Gourielli* case is reported in 33 T.C. 357, and is printed in Appendix A hereto, *infra*, p. App. 1 *infra*. The Opinion of the Tax Court in the *Goldfarb* case is reported in 33 T.C. 568 and is printed in Appendix B hereto, *infra*, p. App. 8 *infra*. The Opinion of the Court of Appeals, affirming both Tax Court decisions, is reported in 289 F. 2d 69 and is printed in Appendix C hereto, *infra*, p. App. 16 *infra*.

Jurisdiction

The judgments of the Court of Appeals were entered on April 25, 1961. *Gourielli* R. 21, *Goldfarb* R. 61a.

The jurisdiction of this Court is invoked under 28 U.S.C. Sec. 1254(1).

Question Presented

Were petitioners entitled to amortize bond premium [in *Gourielli* on purchases of Appalachian Electric Power Company 3¾% 1981 Series First Mortgage Bonds, and in *Goldfarb* on purchases of Arkansas Power & Light Company 4¼% 1983 Eighth Series First Mortgage Bonds] with reference to the special redemption price, as an "amount payable on maturity or earlier call date" within the meaning of Section 125 of the Internal Revenue Code of 1939, or may the statutory reference be qualified to encompass only the amount payable at a higher general redemption price?

Statute Involved

Internal Revenue Code of 1939 as Amended by the Revenue Act of 1942, c. 619, §126, 56 Stat. 798, 822.

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

(v) *Bond Premium Deductions.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125."

"SEC. 125. AMORTIZABLE BOND PREMIUM.

"(a) GENERAL RULE.—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

"(1) *Interest Wholly or Partially Taxable*—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as deduction.

"(b) AMORTIZABLE BOND PREMIUM.

"(1) *Amount of Bond Premium*—For the purposes of paragraph (a), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the

amount payable on maturity or an earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond. In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond.

"(2) *Amount Amortizable*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

"(3) *Method of Determination*—The determination required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary."

Statement

Estate of A. Gourielli* v. *Commissioner of Internal Revenue

The petitioners purchased Appalachian Electric Power Company (hereafter called Appalachian) first

mortgage bonds 3¾ per cent, 1981 series (hereafter called the 1981 series) at 117½ and sold them at 115½ as shown in the following table:

Principal Amount	Date Purchased	Date Sold	Gross Sales Price	Cost	Commissions on Purchase	Commissions on Sale
$130,000	10/ 8/53	11/12/53	$150,150	$152,750	$ 325	$ 325
300,000	10/14/53	11/18/53	346,500	352,500	750	750
110,000	10/23/53	11/27/53	127,050	129,250	275	275
$540,000			$623,700	$634,500	$1,350	$1,350

The purchases were made through the New York brokerage firm of Hirsch & Company. The purchase price was paid in cash.

The issuance and redemption of the bonds were governed by the provisions of the Mortgage and Deed of Trust dated December 1, 1940 (Ex. 2-B).[1] Pursuant thereto, the bonds were redeemable prior to maturity at the option of Appalachian upon thirty days' call notice at either a general redemption price payable out of general funds or a special redemption price payable out of special funds. During the twelve-month period ending May 31, 1954, the general redemption price was $105⅜ and the special redemption price was $102⅜.

The governing indenture required that cash be deposited annually with the corporate trustee pursuant to two formulae. One was a percentage of the original indebtedness (Ex. 3-C, 28-30). Amounts deposited pursuant to this provision could be used only for

[1] "Ex." references are to exhibits which are separately certified in the *Gourielli* record herein.

the redemption at the special price of the 1981 series bonds. The other formula was a percentage of gross revenues, less the amount spent during the year on maintenance (Ex. 2-B, 151-160). Amounts deposited pursuant to this provision could be used for redemption of any of the series issued under the indenture at the special call price. In each case the company had the option, with certain limitations, of depositing bonds or certifying property additions in lieu of making deposits in cash. Appalachian elected not to make cash contributions. Instead, it certified property additions (Ex. 4-D, Appendix [hereinafter App.] 5a-6a). The indenture also provided that bonds of any series may be redeemed at the special price from the proceeds of released properties (Ex. 2-B, Sec. 65; Ex. 3-C, Sec. 2).

While owned by petitioners, the 1981 series bonds had the highest interest and the second farthest maturity date of all series of bonds issued pursuant to the Mortgage and Deed of Trust. Petitioners' expert witness testified that because of these facts the 1981 series would be the first bonds to have been called if the company had decided to exercise its right of call at any time that petitioners owned the bonds (28-29, 38).[2] However, at the date of trial, none of the outstanding First Mortgage Bonds of the Company had ever been redeemed at either the special or general price.

Pursuant to Section 125 of the Internal Revenue Code of 1939 and Treasury Reg. 118, Sec. 39.125(b)-2,

[2] References are to the pages of the *Gourielli* Certified Record herein.

petitioners elected to amortize bond premium to the 30-day call date. Petitioners claimed on their return for 1953 a deduction of $83,056.07 as amortization of bond premium based upon the special call price of $102⅜. Respondent contended that an amortization deduction was proper only if based upon the general call price of $105⅜. Respondent accordingly disallowed $18,225 of the amount claimed, representing that portion of the amortization deduction equal to the difference between the general and special call prices.

The Tax Court sustained the determination of the Commissioner and the Court below affirmed the decision of the Tax Court.

Jacob A. and Bertha L. Goldfarb v.
the Commissioner of Internal Revenue

The petitioners purchased Arkansas Power & Light Company (hereafter called Arkansas) 4¼% 1983 Eighth Series First Mortgage Bonds at prices ranging between 109⅝ to 111, and sold them at an average price of 105-2/5, as shown in the following table:

Principal Amount	Date Purchased	Date Sold	Gross Sales Price	Cost	Commissions on Purchase	Commissions on Sale
$200,000	11/20/53	6/16/54	$210,800	$220,000	$ 500	$350
20,000	11/20/53	6/16/54	21,080	21,925	50	35
280,000	11/23/53	6/16/54	295,120	310,800	700	490
$500,000			$527,000	$552,725	$1,250	$875

The purchases were made through the New York brokerage firm of Timmins & Co. The purchase price was paid in cash.

The issuance and redemption of the bonds were governed by the provisions of the Mortgage and Deed of Trust dated as of October 1, 1944 (Ex. 1-A),[3] the Third Supplemental Indenture dated as of October 1, 1949 (Ex. 2-B) and the Seventh Supplemental Indenture dated as of June 1, 1953 (Ex. 3-C). Pursuant thereto, the bonds were redeemable prior to maturity at the option of Arkansas upon thirty days' call notice at either a general redemption price payable out of general funds or a special redemption price payable out of special funds. During the twelve month period ending May 31, 1954, the general redemption price was $105.36 and the special redemption price was $101.36.

Under the governing indenture provisions, cash contributions to one of the following funds could be used for redemption of Arkansas bonds of the Eighth Series at the special redemption price: Sinking or Improvement Fund; Maintenance and Replacement Fund; Eminent Domain Fund, (Ex. 3-C, Sec. 1 (II)). Arkansas, where it otherwise would have been required to contribute cash to a Fund, could elect alternative options such as the certification of property additions or the waiver of its right to issue additional bonds. The indenture also provided that the bonds could be redeemed at the special price from the proceeds of released property. (See Ex. 1-A, Art. XI.) Arkansas elected the available alternatives and did not make Fund cash contributions.

Pursuant to Section 125 of the Internal Revenue Code of 1939 and Treasury Reg. 118, Sec. 39.125(b)-2, petitioners elected to amortize bond premium to the

[3] "Ex." references are to exhibits which are separately certified in the *Goldfarb* record herein.

30-day call date. Petitioners claimed on their return for 1953 a deduction based upon amortization of bond premium to the special call price of $101.36. Respondent contended that an amortization deduction was proper only if based upon the general call price of $105.36. Respondent accordingly disallowed $20,000 of the amount claimed, representing that portion of the amortization deduction equal to the difference between the general and special call prices.

The Tax Court sustained the determination of the Commissioner and the Court below affirmed the decision of the Tax Court.

Reasons for Granting the Writ

1. Directly in conflict with the decision of the Second Circuit in the instant cases is the decision of the Court of Appeals for the Sixth Circuit in *Parnell* v. *United States*, 272 F. 2d 943 (6th Cir. 1959).[4] The existence of this direct conflict was noted by the Second Circuit in its opinion herein. (*Gourielli* R. 19, *Goldfarb* R. 59a).

The taxpayer in *Parnell* purchased Appalachian Electric Power bonds of the same series as those purchased by the *Gourielli* petitioners, and computed bond premium thereon with reference to the special redemption price of the bonds. (The indenture provisions applicable to the Arkansas Power & Light Company bonds purchased by the *Goldfarb* petitioners were not materially different from those applicable to the Appalachian bonds.) In *Parnell*, as in the in-

58-2 U.S.T.C. par. 988

[4] For convenience the opinion of the District Court, ~~167 F. Supp. 565~~ (M.D. Tenn. 1958) which was affd. per curiam by the Sixth Circuit, is printed as Appendix D, *infra*, p. App. 32 *infra*.

stant cases, the Commissioner challenged the use of the special redemption price. The District Court held:

> "... the court is persuaded that the method employed by the taxpayers is authorized by the applicable statutes when construed in view of their wording and legislative history. Nor can the court agree with the argument of the defendant that the 'special call price was a mere sham and taxpayers' attempt to amortize their bonds with respect to such price was unreasonable.' The Court is convinced that the special call price provided for in the bonds in question is altogether reasonable and realistic." 187 F. Supp. 576.

Similarly, in *Evans* v. *Dudley,* 188 F. Supp. 9 (W.D. Pa. 1960), the court rejected the Commissioner's position and held that under the applicable law,[5] a deduction for amortization to the special redemption price was proper.

2. The question presented is of importance in the administration of the federal tax laws.

Settlement of the question by this Court is in the public interest, for petitioners cases are representative of a problem confronting many taxpayers. Indeed, the very question raised here, and on which the Second and Sixth Circuits have divided, is presented in a number of cases now pending before the Appellate Division of the Treasury Department, the Tax Court, the District Courts, and the Court of Appeals

[5] In *Evans* the year in issue was controlled by Section 171 of the 1954 Code, as originally enacted. However, the bonds in question were issued prior to January 22, 1954. Therefore the applicable law was identical to that of Section 125 of the 1939 Code.

for the Third Circuit. Among these pending cases are the following:

David C. and Anna S. Anchin, Tax Court Docket No. 69650;

Frederick J. and Gladys N. Flemming, Tax Court Docket No. 84463;

Maysteel Products, Inc. v. *Commissioner,* on remand to the District Court from the decision of the Seventh Circuit, 287 F. 2d 429 (March 7, 1961);

Evans v. *Dudley,* 188 F. Supp. 9 (W.D. Pa. 1960) on appeal to the Third Circuit.

The question is essentially one of statutory interpretation. In the Congressional Committee reports on Section 171 of the Internal Revenue Code of 1954, the section dealing with deduction for premium amortization on callable bonds (successor to Section 125 of the Internal Revenue Code of 1939, the statute involved in the instant cases), it was recognized that the 1939 Code authorized a deduction where "the call feature [was] nominal or inoperative."[6] Until removed prospectively by Section 13 of the Technical Amendments Act of 1958, 72 Stat. 1606, 1610, the amortization opportunity remained a part of the tax law.[7]

Prior to January 1, 1958, the effective date of the 1958 Act, there were numerous issues and acquisitions of bonds containing special call price provisions. Disparate tax treatment resulting solely from a fortuity of forum or circuit can be prevented only through the

[6] H. R. Rep. No. 1337, 83d Cong. 2d Sess. 26-27 (1954).

[7] See S. Rep. No. 1983, 85th Cong. 2d Sess. 22-23 (1958).

resolution by this Court of the question presented herein.

3. The decision below of the Second Circuit conflicts, not only with the decision of the Sixth Circuit affirming *Parnell* v. *United States, supra,* but also with applicable decisions of this Court.

This Court's decisions make it plain that in dealing with a tax statute, it is not the business of the judiciary to restrict the application of the legislative text when Congress failed to do so. *Lewyt Corporation* v. *Commissioner,* 349 U. S. 237 (1955); *Commissioner* v. *Korell,* 339 U. S. 619 (1950); *United States* v. *Merriam,* 263 U. S. 179 (1923).

Thus, in the *Lewyt* case, *supra,* this Court said:

> "Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its application. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall. See *Bullen* v. *Wisconsin,* 240 U.S. 625, 630."

In construing Section 125 of the 1939 Code, the very provision involved in the instant cases, this Court rejected the attempt of the Commissioner of Internal Revenue to import a restriction into the statute analogous to the restriction he seeks to insert here. *Commissioner* v. *Korell,* 339 U.S. 619 (1950). This Court stated:

> "Petitioner concedes that the bonds purchased

by respondent are within the reach of Sec. 125, but he urges that this case does not involve the kind of premium which Congress had in mind. The argument is that this premium was paid for the conversion privilege, whereas Congress intended to include only that premium (entitled 'true' premium by petitioner) which is paid for securing a higher rate of interest than the market average and for nothing else. We reject this argument as inapposite to the structure of the statute, unsupported by the legislative history and inconsistent with the normal use of the term 'bond premium'. (339 U. S. 624)

* * * *

"No attempt to define and distinguish the reasons for paying premium mark the pertinent Treasury Regulations, 111, §29.125. They mirror the structure of the statute and are constructed in terms of 'bonds'. Again, we note that the bonds here involved are without question embraced by the statutes. (339 U. S. 624-625)

* * * *

"The legislative history fails to intimate that Congress intended to confine the deduction to bonds the premium on which was paid for a higher-than-market interest rate. At most, petitioner's presentation of the legislative materials suggests that Congress may have had the bondholder who was seeking a higher interest rate primarily in mind; but it does not establish that Congress in fact legislated with reference to him exclusively. (339 U. S. 626)

* * * *

"We adopt the view that 'bond premium' in §125 means any extra payment regardless of the reason therefor, in accordance with the firmly established principle of tax law that the ordinary meaning of terms is persuasive of their statutory meaning.

"We conclude that Congress made no distinctions based upon the inducements for paying the premium. Congress delimited the bond premium it wishes to make amortizable in terms of categories of bonds, and there is no doubt that respondent purchased bonds which are included within the purview of §125. Respondent is therefore entitled to this deduction and the judgment below is

Affirmed." (339 U. S. 627-628)

The principles and reasoning of the *Korell* case are directly applicable to the instant cases.

In the instant cases, respondent concedes that the bonds involved are embraced by Section 125 and that the bond premium is determinable with reference to the "amount payable on earlier call date". However, respondent departs from the text of the statute to define "the amount payable" on a basis nowhere suggested or authorized in the legislative materials. The respondent would limit the pertinent stautory words, "the amount payable . . . on earlier call date," to include the amount payable at a general call price and not the amount payable at a special call price.

As in the *Korell* case, respondent's argument is not supported by the statute or legislative history. No attempt to define and distinguish special and general

redemption prices as "the amount payable" marks the Regulations pertinent to the *Gourielli* and *Goldfarb* cases. In such circumstances "the firmly established principle of tax law" is "that the ordinary meaning of terms is persuasive of their statutory meaning." The ordinary meaning of the words "amount payable on earlier call date" includes the special redemption price.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

HORACE S. MANGES
Attorney for Petitioners
in *Gourielli* and *Goldfarb*

Of Counsel
SQUADRON, ALTER & WEINRIB
WEIL, GOTSHAL & MANGES

APPENDIX A

Opinion of the Tax Court—Gourelli

33 T.C. 357

TAX COURT OF THE UNITED STATES

ESTATE OF A. GOURIELLI, DECEASED, The Hanover Bank, Executor, and HELENA GOURIELLI, surviving wife, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 68443. Filed November 30, 1959.

BOND PREMIUM AMORTIZATION—TWO SIMULTANEOUS CALL PRICES—SECTION 125.—The taxpayers have failed to show that the deduction for amortization of bond premiums should be the excess of the cost of the bonds over a "special redemption" price instead of the excess of cost over the "regular redemption" price, as allowed by the Commissioner.

DAVID ALTER, Esq., and HUBERT THURSCHWELL, Esq., for the petitioners.

JOHN J. MADDEN, Esq., and WILLIAM F. CHAPMAN, Esq., for the respondent.

The Commissioner determined a deficiency in income tax of $14,200.92 for 1953. The only issue for decision is whether the deduction for amortization of premiums on bonds under section 125(b) of the Internal Revenue Code of 1939 is limited to the excess of cost over the general redemption rate of 105.375 as contended by the Commissioner or is the excess of cost over the special redemption rate of 102.375 as contended by the petitioners.

Appendix A

Findings of Fact

A. Gourielli and Helena Gourielli were husband and wife during 1953 and filed a joint income tax return for that year with the district director of internal revenue for the Upper Manhattan District of New York. The husband died before the filing of the petition and the wife survives.

Gourielli and his wife, hereafter referred to as petitioners, purchased Appalachian Electric Power Company (hereafter called Appalachian) first mortgage bonds 3¾ per cent, 1981 series (hereafter called the 1981 series) at 117½ and sold them at 115½ as shown in the following table:

Principal Amount	Date Purchased	Date Sold	Gross Sales Price	Cost	Commissions On Purchase	Commissions On Sale
$130,000	10/ 8/53	11/12/53	$150,150	$152,750	$ 325	$ 325
300,000	10/14/53	11/18/53	346,500	352,500	750	750
110,000	10/23/53	11/27/53	127,050	129,250	275	275
$540,000			$623,700	$634,500	$1,350	$1,350

The purchases were made through a broker. The purchase price was paid in cash.

The mortgage and deed of trust securing the Appalachian bonds, as amended in section 20C, contained, *inter alia,* provisions here summarized as follows:

> The 1981 series, issued in denominations of $1,000, were to mature on June 1, 1981. Interest was payable on June 1 and December 1 of each year. The company, at its option or by operation of various provisions of the mortgage and deed of

trust, could redeem 1981 series bonds at any time and from time to time upon notice published in a New York newspaper at least once in each of four consecutive calendar weeks, the first publication to be at least 30 days but not more than 90 days prior to the date fixed for redemption. The redemption would be at the principal amount thereof and accrued interest to such date of redemption, together, if redeemed otherwise than by the use of cash deposited pursuant to sections 20 or 40 of the indenture and otherwise than by the use of proceeds of released property or the proceeds of insurance, with a premium equal to a percentage of the principal amount thereof determined as set forth in a schedule headed "Regular Redemption Premium", and if redeemed by the use of cash deposited pursuant to sections 20 or 40 of the indenture, by the use of proceeds of released property or the proceeds of insurance, with a premium equal to a percentage of the principal amount determined as set forth in the schedule under the heading "Special Redemption Premium."

The schedule referred to contains three columns. The left-hand one headed "Year" begins with 1952 and ends with the year 1979. The next column is headed "Regular Redemption Premium" and the right-hand column is headed "Special Redemption Premium." The following appears under those two columns: "(If redeemed prior to June 1 of the calendar year stated and subsequent to the last day of May of the calendar year next preceding such year)". Opposite each

year a percentage is shown under each of the other two headings. Those shown under "Regular Redemption Premium" begin with 5¾ per cent and decline at the rate of ¼ per cent for some years and ⅛ for others until they reach ⅜ of 1 per cent for the year 1979. The percentages under "Special Redemption Premium" are 2⅜ per cent for the first 3 years, 2¼ per cent for the next 3 years, then decline ⅛ per cent at intervals until they get to be ⅜ of 1 per cent in 1979. The two columns are identical for the last 3 years, and below the schedule the following appears: "and without premium in either case if redeemed on or after June 1, 1979 and prior to maturity."

The petitioners elected to amortize the premiums paid on the bonds and claimed on their return for 1953 a deduction of $83,056.07 as amortization of those bond premiums based upon the "special" call price. The Commissioner allowed the deduction to the extent of $64,831.07 and disallowed $18,225 of the amount claimed.

The following table shows each series of Appalachian's first mortgage bonds, all issued under the same mortgage and deed of trust applicable to the bonds here in issue:

Interest Rate	Due	Issued	Total Amount
3¼%	December 1, 1970	January 1941	$ 70,000,000
3⅛%	December 1, 1977	January 1948	28,000,000
2⅞%	March 1, 1980	April 1950	25,000,000
3¾%	June 1, 1981	July 1951	17,000,000
3½%	October 1, 1982	Nov. 1952	17,000,000
3½%	December 1, 1983	January 1954	20,000,000

Appendix A

Interest Rate	Due		Issued		Total Amount
4⅝%	March 1,	1987	April	1957	29,000,000
4 %	May 1,	1988	June	1958	25,000,000
				Total	$231,000,000

Appalachian has never called, redeemed or owned any of the above bonds, all of which are still outstanding in the amounts as originally issued.

The company had $1,685,114.65 available in 1953 for the call of 1981 series bonds at the "regular redemption" price, of which $1,359,155.02 was "actually certified in the year following the applicable year."

The prevailing rate of interest on bonds during 1952, 1953 and 1954 never fell below the prevailing rate for 1951.

No conditions existed in 1953 which would have warranted the calling of any Appalachian bonds. The business of the company was then expanding and its debt was increasing. The only fund which Appalachian could have used in 1953 to retire any part of the 1981 series at the "special redemption" price was "Releases (Cash) $42,626.30" which was withdrawn by the company on April 6, 1955. There was no likelihood that the debtor would consider redeeming any of the 1981 series during 1953.

All stipulated facts are incorporated herein by this reference.

Opinion

Murdock, *Judge*: Section 125 entitled "Amortizable Bond Premium" allows deductions through amortization of premiums paid on bonds, the interest

of which is wholly taxable. The amortizable premium here is the excess of the cost over "the amount payable on maturity or on earlier call date", here on a call date long prior to maturity. The cost of these bonds subject to amortization is stipulated, the total cost of the bonds, including commissions paid at that time. The parties disagree only as to the amount by which these bonds can be amortized, the amount payable on a call date prior to maturity. They were actually sold at a profit since the basis was reduced by the amortization allowed, although they were sold for less than their original cost. The attraction presumably of the petitioners' investment in these Appalachian bonds was to obtain short-term capital gains to offset already realized short-term capital losses.

The question is—which of two redemption prices, each exercisable on the same call date, is to be used in computing a deduction for amortization of bond premiums. That question is not recognized or dealt with directly in section 125, its legislative history or the regulations. The Commissioner has allowed amortization of the bond premiums to the extent that the cost exceeds the "regular redemption" price. He not only does not argue that he was wrong in allowing that amount to be amortized but he affirmatively contends that the deduction of the excess of cost over the "regular redemption" price is proper. Cf. *Commissioner* v. *Korell,* 339 U. S. 619. He disallowed as a deduction the difference between the higher "regular" and the lower "special redemption" prices, and he contends that that disallowance was proper. However, he makes no argument in his briefs against the amortization of the excess of the cost over the "special re-

demption" price that is persuasive or that would not apply as well to the amortization which he has allowed. The petitioners have failed to advance any adequate reason for amortizing the difference between cost and the "special redemption" price. In other words, neither party has supported its contention by a persuasive argument. The Tax Court has no justification for changing the Commissioner's determination since it is presumed to be correct and the burden of proving otherwise is upon the petitioners.

The Court is not persuaded that these petitioners, who held these bonds for only 35 days, are entitled under this regulation to deduct the difference between cost and the "special redemption" price.[1] In fact, the record shows that except for an unsubstantial portion, the bonds could not have been redeemed at the "special redemption" price at any time while petitioners owned them. The presumption of correctness attaching to the determination of the Commissioner is not a very satisfactory basis on which to rest a decision, but there is nothing factually or legally beneficial to petitioners in this case upon which a decision in their favor can be rendered.

Decision will be entered for the respondent.

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[1] Section 125 seems to make available a tax advantage through long-term capital gains and the benefit demonstrated by the present case of offsetting capital losses, although neither possibility is mentioned in the legislative history or in the Regulations. See, in this connection, Regs. 118, section 39.125(b)-2.

APPENDIX B

Opinion of the Tax Court—Goldfarb

33 T.C. [redacted]. 568

TAX COURT OF THE UNITED STATES

JACOB A. GOLDFARB, BERTHA L. GOLDFARB, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 66899. Filed December 24, 1959.

Held, taxpayer not entitled to deduct, under section 125 I.R.C. of 1939, through amortization, the premium paid on bonds measured by the excess of the cost of bonds over a special redemption price instead of excess of cost over general redemption price. *Estate of A. Gourielli, Deceased, et al.,* 33 T.C. [357] (November 30, 1959) followed.

KARL W. WINDHORST, Esq., for the petitioners.

VICTOR H. FRANK, JR., Esq., for the respondent.

MULRONEY, *Judge:* Respondent determined a deficiency in the petitioners' income tax for the year 1953 in the amount of $14,708.16. The only issue for decision is whether the petitioners are entitled to a deduction for the amortization of bond premiums under section 125 (b) of the Internal Revenue Code of 1939[1] measured by the excess of cost over the special redemption rate of $101.36, as contended by the petitioners.

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[1] All section references are to the Internal Revenue Code of 1939, as amended.

Appendix B

Findings of Fact

Some of the facts have been stipulated and they are hereby incorporated by this reference.

Jacob A. Goldfarb and Bertha L. Goldfarb, husband and wife, are residents of New York City, New York. They filed a joint income tax return for the year 1953 with the district director of internal revenue for the Upper Manhattan District of New York. Jacob A. Goldfarb will hereinafter be called the petitioner.

Petitioner purchased through a broker on November 20, 1953, $20,000 face amount of Arkansas Power and Light Company 1st 4¼ per cent 30-year bonds (dated June 1, 1953) at 110, costing him $220,500; $20,000 face amount of identical bonds at 109⅝, costing him $21,975; and on November 23, 1953, $280,000 face amount of identical bonds at 111, costing him $311,500. The total cost of the bonds to the petitioner was $553,975, which included brokerage commissions of $1,250. The bonds will hereafter sometimes be called the Eighth Series bonds, or the Arkansas 4¼ per cent bonds. Arkansas Power and Light Company will hereafter be called Arkansas.

The purchase price in the amount of $553,975, plus accrued interest in the amount of $10,488.05, was paid by the petitioner in the following manner: by personal check in the amount of $74,463.05; and by obtaining a loan in the amount of $490,000 at 3½ per cent per annum from the First Wisconsin National Bank of Milwaukee, on petitioner's personal six months' note dated November 27, 1953 and the deposit as security of the $500,000 face amount of the Arkansas 4¼ per cent bonds. On May 27, 1954 petitioner borrowed

$235,000 from the First National Bank of Kansas City on his personal 60-day 3 per cent note, and deposited as security $250,000 face amount of Arkansas 4¼ per cent bonds which had been transferred from the First Wisconsin National Bank. On May 28, 1954, the petitioner borrowed $235,000 from the Citizens Fidelity Bank and Trust Company of Louisville, Kentucky, on his personal 60-day 3 per cent note, and deposited as security $250,000 face amount of Arkansas 4¼ per cent bonds which had been transferred from the First Wisconsin National Bank. By May 28, 1954, the petitioner had paid off in full his note given to the First Wisconsin National Bank.

On June 16, 1954 the petitioner sold the $500,000 face amount of Arkansas 4¼ per cent bonds for $527,000, less commissions and selling expenses of $875. Petitioner reported a long-term capital gain on his income tax return for 1954 using a basis of $506,800 for the bonds.

The issuance and redemption of the Arkansas 4¼ per cent bonds were governed by the provisions of the Mortgage and Deed of Trust dated as of October 1, 1944, the Third Supplemental Indenture dated as of October 1, 1949, and the Seventh Supplemental Indenture dated as of June 1, 1953.

The Arkansas 4¼ per cent bonds were redeemable on 30 days' call notice prior to their fixed maturity date at either (1) the general redemption price from general funds or (2) the special redemption price from certain special funds. Both the general and the special redemption prices decreased yearly. The general redemption price was $105.36 if the Arkansas 4¼ per cent bonds were called during the 12-month period

ending May 31, 1954. The special redemption price was $101.36 if the bonds were called during the same period.

All of the issued and outstanding Arkansas 4¼ per cent bonds were redeemed by Arkansas at the general call price of $105.18 on April 18, 1955.

The Arkansas 4¼ per cent bonds were redeemable at the option of the company at the special call price only for cash if such cash were available in the sinking and improvement fund of the Arkansas 4¼ per cent bonds, the maintenance and replacement fund, or the fund for released property or fund for property taken by eminent domain in accordance with the provisions of the Mortgage and Deed of Trust and Supplementary Indentures.

Arkansas had the option to transfer certain cash to the maintenance and replacement fund, and the option to transfer certain cash to the sinking and improvement fund of the Arkansas 4¼ per cent bonds. Any cash available in these funds or in the released property fund and eminent domain fund could have been used to redeem by lot the Arkansas 4¼ per cent bonds. If Arkansas had exercised the options, it could have made available sufficient cash in the maintenance and replacement fund (or, to the extent permitted pursuant to Article 2, Section 2 of the Seventh Supplemental Indenture, in the sinking and improvement fund of the Arkansas 4¼ per cent bonds), or, if certain events had transpired, there might have been available sufficient cash in the released property fund or in the eminent domain fund which could have permitted Arkansas to redeem the Arkansas 4¼ per cent bonds pursuant to the terms of the mortgage and Deed

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of Trust and Supplemental Indentures, and which could have resulted in the redemption at the special call price prior to December 31, 1953, of all the Arkansas 4¼ per cent bonds owned by the petitioner.

No cash was placed in the sinking and improvement fund for the Arkansas 4¼ per cent bonds during the time these bonds were outstanding. In lieu of the cash to be placed in the sinking and improvement fund, Arkansas elected other options, such as taking a credit for the amount of bonds, the authentication and delivery of which would have been delivered under the mortgage but which authentication and delivery had been waived. No cash was placed in the maintenance and replacement fund of Arkansas during the time that the Arkansas 4¼ per cent bonds, or any of the other bond issues, were outstanding. In lieu of the cash requirements for the maintenance and replacement funds of the various series of bonds, including the Arkansas 4¼ per cent bonds, during the time that said bonds were outstanding, expenditures for maintenance, repairs and gross property additions were certified by Arkansas. No property was released and no property was taken by eminent domain and, therefore, no cash was placed in the released property fund or property taken by eminent domain fund of the Arkansas 4¼ per cent bonds.

It was the practice of Arkansas to use its cash, with which it could have satisfied its obligations to the certain funds, in its substantial construction program.

No cash was placed in the general maintenance and replacement fund or in the sinking or improvment fund of the following first mortgage bonds issued by

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Arkansas during the time that these bonds were outstanding:

3⅛s Series due 1974
2⅞s Series due 1977
3⅛s Series due 1978
2⅞s Series due 1979
2⅞s Series due 1980
3⅝s Series due 1981
3½s Series due 1982
3¼s Series due 1984
3⅜s Series due 1985

These issues are still outstanding and have not been redeemed at either their general or special call price.

The business of Arkansas was expanding. Its total electric operating revenues had more than doubled in the 10-year period ending with 1958. Its construction program was substantial. There was no likelihood that Arkansas would redeem its Arkansas 4¼ per cent bonds at the special redemption price in 1953.

Interest rates on utility bonds declined in 1953 and 1954.

Petitioner claimed a deduction of $47,175 on his 1953 income tax return for amortization of the bond premium paid on his purchase of the Arkansas 4¼ per cent bonds, based on the excess of the total cost of $553,975 over the total special redemption price of $506,800 ($101.36 per $100 face amount) specified for redemption during the 12-month period ending May 31, 1954. The respondent allowed the deduction for amortization of bond premium to the extent of $27,175 and disallowed the balance thereof amounting to $20,000.

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Opinion

The only question is whether the petitioners are entitled to a deduction for amortization of bond premiums under section 125 equal to the excess of cost over the special redemption price. This exact question was recently decided by this Court in *Estate of A. Gourielli, Deceased, et al.*, 33 T.C. [357] (Nov. 30, 1959), where we rejected the petitioner's contention that the amortization deduction under section 125 should be measured by the excess of bond cost over the special redemption price. That case is controlling here.

There is no compelling argument presented here for permitting the special redemption price to measure the total amount of premium to be amortized. Under the facts before us, the special redemption price is unrealistic. Here it can be said as was said in the *Gourielli* case that the record shows the bonds could not have been redeemed at the special redemption price at any time while petitioners owned them. Cash for such redemption could only come from certain specified funds, and the bonds in question were redeemable only if such cash were available. No cash was ever placed in any of the funds maintained by Arkansas for this purpose. Instead, Arkansas met its obligations as to these special funds under the pertinent mortgages and deeds of trust by selecting certain options open to it which did not involve cash. The business of Arkansas was expanding and it was engaged in a substantial construction program, and it was its practice to use its available cash for such program.

Under the authority of *Estate of A. Gourielli, Deceased, et al., supra*, we sustain respondent.

Decision will be entered for the respondent.

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TAX COURT OF THE UNITED STATES

WASHINGTON

JACOB A. GOLDFARB, BERTHA L. GOLDFARB, *Petitioners,* *v.* COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	Docket No. 66899

DECISION

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, filed December 24, 1959, it is

ORDERED AND DECIDED: That there is a deficiency in income tax for the year 1953 in the amount of $14,708.16.

Enter:

(Signed) JOHN E. MULRONEY
Judge

Entered Dec. 28, 1959

APPENDIX C

Opinion of the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 239 and 164—October Term, 1960.

(Argued March 7, 1961 Decided April 13, 1961.)

Docket Nos. 26258 and 26324

ESTATE OF A. GOURIELLI, Deceased, THE HANOVER BANK, Executor, and HELENA GOURIELLI, Surviving Wife,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

JACOB A. and BERTHA L. GOLDFARB,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

LUMBARD, *Chief Judge,*
WATERMAN and FRIENDLY, *Circuit Judges.*

Petitions to review decisions of the Tax Court, 33 T. C. 357, Murdock, *J.*, and 33 T. C. 568, Mulroney, *J.*, sustaining the Commissioner's findings of deficiencies

in income taxes as result of disallowances of amounts claimed as amortizable bond premium. Affirmed.

DAVID ALTER (Squadron, Alter & Weinrib, and Hubert Thurschwell, on the brief), New York, N. Y., *for Petitioners Estate of Gourielli, et al.*

THEODORE TANNENWALD, JR. (Weil, Gotshal & Manges, and Martin D. Ginsburg, on the brief), New York City, N. Y., *for Petitioners Jacob A. and Bertha L. Goldfarb.*

JAMES P. TURNER, Att'y, Dept. of Justice (Abbott M. Sellers, Acting Ass't Att'y Gen'l and Lee A. Jackson, Melva M. Graney and John A. Bailey, Att'ys, Dept. of Justice), Washington, D. C., *for Respondent in both cases.*

FRIENDLY, *Circuit Judge:*

The issue in these two cases is whether, in a tax year, 1953, governed by §§23 (v) and 125, added to the 1939 Code by the Revenue Act of 1942, c. 619, §126, 56 Stat. 798, 822, taxpayers who purchased bonds callable on 30 days' notice may deduct, in addition to the excess of their basis over the redemption price at which the issuer could freely call all or any part of the issue, the excess of that price over a lower one at which the issuer could call bonds only out of specially defined funds. In both cases the Tax Court sustained determinations of the Commissioner adverse to the

taxpayers. We likewise hold the additional deductions claimed by the taxpayers may not be taken on the facts here. We set forth the relevant sections of the Code in the margin;[1] we shall follow the parties, and the bond indentures, in referring to the higher of the two prices as a "general" or "regular" redemption price, and to the lower as a "special" redemption price.

In October, 1953, Mr. and Mrs. Gourielli purchased $540,000 principal amount of Appalachian Electric Power Company 3¾% bonds, issued in 1951 and due

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[1] "Sec. 23. *Deductions from Gross Income.*
In computing net income there shall be allowed as deductions:

* * * *

(v) *Bond Premium Deductions.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

Sec. 125. *Amortizable Bond Premium.*

(b) *Amortizable Bond Premium.—Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond. In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary."

in 1981, at 117½; the bonds were retained for somewhat over 30 days and then were sold at 115½. The 1981 series was an issue of $17,000,000 out of a total of $157,000,000 outstanding under the same mortgage at the date of the purchase. During the Gouriellis' ownership, the bonds were stated to be subject to call on 30 days' notice at 105⅜ or, out of certain funds hereafter described, at 102⅜. The taxpayers claimed a deduction for amortization of bond premium of $83,056.07, representing the excess of the cost of the bonds over what would have been received if these had been called at the "special" redemption price of 102⅜; the amortization resulted in the transaction's yielding a short term capital gain. The Commissioner allowed a deduction only of $64,831.07, the excess of the cost of the bonds over what would have been received at the "regular" redemption price of 105⅜.

In late November, 1953, Mr. Goldfarb purchased $500,000 principal amount of Arkansas Power & Light Company 4¼% bonds, issued in 1953 and due in 1983, at an average price of approximately 110½. The 1983 series was an issue of $18,000,000 out of a total of $104,200,000 outstanding under the same mortgage at the date of the purchase. At the time the bonds were stated to be subject to call on 30 days' notice at 105.36 or, out of certain funds hereafter described, at 101.36. Mr. Goldfarb claimed a deduction for amortization of bond premium of $47,175, representing the excess of the cost of the bonds over what would have been received if they had been called at the "special" redemption price of 101.36. The Commissioner allowed a deduction only of $27,175, the excess of the cost of the bonds over what would have been received at the "gen-

eral" redemption price of 105.36. The bonds were sold in June, 1954, for $526,125; petitioners reported a long term capital gain.

In both cases the company's right to redeem the bonds on 30 days' notice, in whole or in part, at the "regular" price was unconditional; in both, the right to redeem at the "special" price was limited to the application to that end of certain funds narrowly defined in the indentures. In both, also, when less than an entire series was to be called, the bonds to be redeemed were to be determined by lot.

The Appalachian bonds held by the Gouriellis were redeemable at the "special" price only "by the use or application of cash deposited pursuant to Section 20 or Section 40 of the Mortgage or by the use of proceeds of released property or the proceeds of insurance." Section 20 of the Mortgage required the company, on or before March 1 of each year, beginning with 1953, to deliver to the mortgage trustee an amount in cash or principal amount of bonds of the 1981 Series equal to 1% "of the greatest principal amount of bonds of the 1981 Series theretofore at any one-time outstanding," less credits of 60% of the cost or fair value of any property additions and of 100% of the principal of any bonds which the company would have been entitled to issue, under a provision permitting such issuance in an amount not exceeding 70% of the cost or fair value of property additions, but had elected not so to issue. Any cash so paid might be withdrawn upon certification that the company was entitled to issue bonds and had waived its right to do so, or, at the direction of the company, might be used for the purchase or redemption of bonds of the 1981 Series. Section 40 provided that, within

four months after the close of each calendar year, the company would furnish the mortgage trustee with a certificate showing whether its expenditures for repairs, maintenance or replacement of the mortgaged property and credits claimed for property additions were more or less than specified percentages of operating revenues; if less, the company was to deposit an amount in cash or bonds equal to the deficiency. The company could withdraw any cash or bonds so deposited against an excess shown in a subsequent certificate; it could withdraw cash against the deposit of bonds at any time; and it also had the same rights with respect to the cash as have been described in the case of Section 20 the purchase or redemption of bonds being here permitted without segregation as to series. This latter right existed also as to cash paid to the trustee as insurance proceeds or for the release of property. Up to the fall of 1953 no cash had ever been paid the trustee pursuant to Section 20 or Section 40, the company's obligations under these sections having been satisfied by credits for property additions. Neither had anything been paid as insurance proceeds. Certain amounts had been paid in connection with the release of property but all these save $184,837.43 had been withdrawn. There is no evidence that any substantial payments for insurance or the release of property were in prospect. It would have been extremely poor business for the company to incur the expenses incident to a call for such a small sum as was available; the chance that the company would engage in so ill-advised an endeavor during petitioners' brief ownership was thus exceedingly remote; and the hazard that any significant number of petitioners' bonds would be called during that period was infinitesimal.

Appendix C

The Seventh Supplemental Indenture under which the Arkansas Power & Light Company bonds of 1983 were issued provided these could be redeemed at the "special" price only out of "cash delivered to or deposited with the Corporate Trustee pursuant to the provisions of Section 39 or Section 64 of the Mortgage or of Section 2 hereof or Section 3 of the Third Supplemental Indenture or with the proceeds of Released Property." Section 39 of the Mortgage as modified by Section 3 of the Third Supplemental Indenture required that, within 90 days after the close of the calendar year, the company should file a certificate in regard to maintenance and in case of a deficiency make a payment in cash, on lines broadly similar to these described above in connection with the Appalachian mortgage. Cash so paid might be withdrawn against property additions or waiver of the right to issue bonds to which the company was entitled, or might be directed to be applied to the purchase or redemption of bonds; the trustee was so to apply any cash left with it for five years. Section 64 provided for the payment to the corporate trustee of sums received as the result of the taking of property by eminent domain or its sale to governmental bodies. Section 2 of the Seventh Supplemental Indenture provided that, on or before October 1 of each year beginning with 1954, the company was to deliver to the trustee a certificate showing the greatest principal amount of bonds of the 1983 Series outstanding at any one time prior to January 1 of such year, less the amount retired by application of the proceeds of insurance, the release or other disposition of property, or the taking of property by eminent domain, and less also the prin-

cipal amount of bonds the right to the issuance of which had been waived pursuant to certain clauses of the mortgage. Along with the certificate the company was to pay, in cash or 1983 bonds, 1% of this balance, less the principal amount of any bonds which the company had the right to issue on the basis of property additions or retirement of 1983 bonds, if the company elected to waive its right to issue such bonds and thereby avail itself of this credit. Section 2 contained a provision permitting the company to anticipate these sinking fund requirements; however, if cash were so paid, bonds called for redemption prior to January 1 of the calendar year in which the payment would otherwise have become due would be redeemable at the "general" rather than the "special" redemption price. In fact, during 1953 the trustee under the Arkansas Power & Light Co. mortgage held no cash under any of these provisions, with respect to either the 1983 series or any other, and there is no evidence that any receipts were in prospect. The company had satisfied its covenant under the maintenance clause; no property had been taken by governmental bodies; nothing had been paid for released property; and the company had availed itself of the credit to eliminate its obligation to pay cash or bonds into the sinking funds for earlier series, no sinking fund obligation with respect to the 1983 series having yet accrued. When the Arkansas bonds were purchased by Mr. Goldfarb in late November, 1953, there was thus no real possibility that any of them would be called at the "special"

price that year.[2] On April 18, 1955, the entire issue of 4¼s of 1983 was called at the "general" redemption price, then 105.18.

Despite superficial similarity in language, the two redemption provisions serve entirely different purposes and have quite different effects. The primary purpose of the provision giving the right to call all or part of the issue at any time is to enable the company to take advantage of a fall in interest rates; the relatively high premiums demanded on such a call,

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[2] The stipulation of facts in the *Goldfarb* case recites that if Arkansas Power & Light Company had exercised certain options:

> "it could have made available sufficient cash in the maintenance and replacement fund (or to the extent permitted pursuant to Article 2, Section 2 of the Seventh Supplemental Indenture in the sinking and improvement fund of the Arkansas 4¼% bonds) or, if certain events had transpired, there might have been available sufficient cash in the released property fund or in the eminent domain fund which could have permitted the Company to redeem the Arkansas 4¼% bonds pursuant to the terms of mortgage and Deed of Trust and Supplemental Indentures thereto and which could have resulted in the redemption at the special call price prior to December 31, 1953, of all of the bonds of the Company having a face value of $500,000.00 owned by petitioner Jacob A. Goldfarb."

We read this to mean only that the company had resources sufficient to enable it to make required payments in cash rather than otherwise—not that the indenture entitled it to pay cash in any amount it chose and avail itself of the "special" redemption price. The indenture gave the company no right to anticipate anything save sinking fund payments, and that right was carefully hedged as regards redemption price as noted in the text; although the company could have paid any amount it chose, no 1983 bonds could have been called at the "special" redemption price in 1953 since no sinking fund payment was due that year. If the quoted language from the stipulation means otherwise, we must disregard it in favor of the controlling provisions of the indentures, which were annexed, *National Marking Mach. Co.* v. *Triumph Mfg. Co.*, 13 F. 2d 6, 9-10 (8 Cir. 1926); *Daugaard* v. *Hawkeye Security Ins. Co.*, 239 F. 2d 351, 354 (8 Cir. 1956).

initially 5¾% on the Appalachian bonds and 5.36% on the Arkansas, reflect the lenders' determination to exact a substantial price for something that will deprive them of the benefit of what has proved an advantageous bargain. Dewing, The Financial Policy of Corporations (5th ed. 1953), Vol. I, pp. 187-88. In contrast, the so-called "special" redemption price is an incident, itself unfavorable but only mildly so, in a set of provisions requiring the company to protect the underlying security for the benefit of the lenders —by adequately maintaining the mortgaged property, by conserving the proceeds of property destroyed or sold, and by providing against the ravages of time either through adding new property or through retiring bonds. Although the company is given considerable flexibility in providing this protection by means other than the payment of cash and even is entitled under some circumstances to withdraw cash already paid to the trustee, there is always a possibility that the payment of cash will be the only option attractive to the company from a business standpoint; hence the borrower insists upon a right to call in order to avoid the accumulation of idle cash in the sinking fund or the payment of what it deems an excessive price for the purchase of bonds from unwilling sellers. See *Dewing, supra,* at pp. 247-49. Lenders are willing to permit the company to do this at a price lower than in the general redemption clause,[3] since, even in the

[3] For the Appalachian bonds the initial special redemption premium was 2⅜%, for the Arkansas bonds only 1.36%. Both the general and special redemption premiums were to decline as the years passed, the two meeting in 1977 in the case of the Appalachian issue.

event, not generally anticipated in public utility bonds, that the company should elect the cash option, the careful definition of the funds that may be so applied severely limits the amount of bonds that can be called, especially during the early life of the issue when the point is of greatest concern, and the consequent risk to the lenders—save for the eventualities, themselves rare, that a large part of the mortgaged property might be destroyed or condemned. Moreover, for reasons that are sufficiently apparent, there is not the same likelihood of exact correlation between a decline in interest rates and a call at the "special" as at the "general" redemption price. By the same token, although the "general" redemption provision normally tends to prevent the market price of the bond from rising too markedly above the call price, since the very existence of such a premium usually shows that interest rates have fallen to a point producing the hazard of a call,[4] the "special" redemption provision exercises no downward pull of similar magnitude in the usual case, since, if any such call were to be made, it would relate in any year to only a small proportion of the bonds, chosen by lot.

We do not think that when Congress provided in §125 of the Code that the amount of bond premium "shall be determined * * * with reference to the amount payable on maturity or on earlier call date," and allowed the deduction as "amortizable bond pre-

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[4] We say "normally" and "usually" since there was evidence that the large premium over the general redemption price commanded by the bonds here in question in the closing months of 1953 was not unrelated to a demand arising from their attractiveness for tax deduction purposes—even on the narrower view as to the permissible deduction conceded by the Commissioner.

mium" in any year of "the amount of the bond premium attributable to such year," it meant to include an amount payable on a call at a "special" price of which there was no real possibility during the period for which the amortization is being taken and the deduction claimed. The statute does not say the premium is the excess of the basis over "the amount payable on maturity or on earlier call date"; it says the premium shall be determined "with reference to" the two factors. One purpose for using this somewhat oblique language was to encompass the adjustments for unamortized bond premium referred to in the clause immediately following, see Regulations 118, §39.125(b)-1, but that may not have been the only purpose. A sufficient chink was left to give scope for interpretation, as, indeed, there might well have been without this, for even the words "earlier call date" would call for construction. *Ozawa* v. *United States,* 260 U. S. 178, 194 (1922).

We know that Section 125 was added to the Code because "The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results * * * " 77th Cong. 2d Sess., H. R. Rep. No. 2333, p. 47 (1942-2 Cum. Bull. 372, 410). Taxpayers have cited no authority that it is sound accounting practice to provide, within 30 days after acquiring a bond, a reserve large enough to meet not only every risk of call that could eventuate during the amortization period but also one that could not. Cf. *Massey Motors, Inc.* v. *United States,* 364 U. S. 92, 104-06 (1960). Again the House Report tells us that lack of provision for amortization of bond premium had obliged bondholders to pay "a tax,

as upon income, upon that portion of the so-called interest payments which is in reality capital recovered * * * " What this means is that an investor who pays $1,100 for a $1,000 5% uncallable bond maturing in ten years will not in fact receive $500 interest over the decade, but only $400, and only the latter should be taxed as income. Similarly, if the issue were callable at 105 on 30 days' notice in whole or in part at the company's option, the premium might indicate sufficient likelihood of a call that in substance the investor would be paying $1100 and be getting back $1050, and since there was no way of determining when this loss of capital would be all, Congress indulgently allowed him to provide for it at once. This reasoning scarcely applies to a provision entitling the issuer to call what normally is at most a small proportion of the issue each year—at least until the issuer's prospective intention and legal ability to exercise this privilege in a significant way become sufficient to constitute a market factor. Whether a bondholder might be entitled to use a "special" redemption price for computing bond premium if there were circumstances indicating the likelihood of a substantial call at that price when he first elected a method of amortization, or whether, having elected to amortize to a "general" call price, he might be permitted a further deduction for amortization if facts indicating the likelihood of such a call at the "special" price later appeared, we do not find it necessary here to decide.

Taxpayers seek to find support for a conclusion adverse to the Commissioner in a statement in the

reports, quoted in the margin, 83d Corg. 2d Sess., H. R. Rep. No. 1337, pp. 26-27; Sen. Rep. No. 1662, pp. 30-31,[5] accompanying §171 of the 1954 Code, which provided that henceforth amortization could be taken only to a call date more than three years after the date of issuance. Congress' awareness that the rapid amortization of a premium over the redemption price at an early call date, authorized by the 1942 amendment, had opened a loophole that needed to be narrowed,[6] hardly shows it had initially meant to create an even larger one. Neither are we persuaded to these taxpayers' views by the Commissioner's having

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[5] "Amortization of premium on callable bonds (sec. 171)

"Under existing law, a bond premium may be amortised with reference to the amount payable on maturity or on earlier call date, at the election of the taxpayer. In the case of bonds with a very short call feature, such as those providing for call at any time on 30-day notice, the entire premium may be deducted in the year of purchase.

"This provision has given rise to tax-avoidance opportunities. Substantial bond issues have been made subject to a 30-day call, permitting the purchaser to take an immediate deduction for the entire premium against ordinary income. Where the call feature is nominal or inoperative this permits a deduction for an unreal loss, since the market value of the bonds ordinarily remains fairly stable over considerable periods."

[6] The 1954 attempt at narrowing was not effective since "taxpayers found they could accomplish much the same result as under the 1939 Code by using bonds with call dates slightly more than 3 years from the date of the issue of the bonds and by waiting until these bonds are 3 years old before buying or selling them." 85th Cong., 2d Sess., Sen. Rep., No. 1983 (1958), §14. Accordingly the statute was further amended to provide that, for bonds acquired after December 31, 1957, the premium shall be determined "with reference to the amount payable on maturity (or if it results in a smaller amortizable bond premium attributable to the period to earlier call date, with reference to the amount payable on earlier call date) * * *" Technical Amendments Act of 1958, §13(a), 72 Stat. 1606, 1610.

at one time advised other taxpayers that use of the "special" call price was permissible, in unpublished opinions later revoked by Revenue Ruling 56-398, 1956-2 Cum. Bull. 984-87;[7] such opinions are not binding elsewhere, *Goodstein* v. *C. I. R.*, 267 F. 2d 127, 132 (1 Cir. 1959); *Weller* v. *C. I. R.*, 270 F. 2d 294, 298-299 (3 Cir. 1959), cert. denied, 364 U. S. 908 (1960). We realize also that our decision runs counter to at least the one of the two decisions reported sub nom. *Parnell* v. *United States*, 187 F. Supp. 576 (M. D. Tenn. 1958), affd. 272 F. 2d 943 (6 Cir. 1959), that relates to taxpayer Parnell's holding of the same issue of Appalachian Electric Power bonds as were bought by the Gouriellis, and to *Evans* v. *Dudley*, 188 F. Supp. 9 (W. D. Pa. 1960), now under appeal to the Third Circuit. Finally, we do not consider *Commissioner* v. *Korell*, 339 U. S. 619 (1950), much relied on by taxpayers, to be at all controlling in their favor. That decision was concerned with the minuend in §126, whereas our problem relates to the subtrahend. The Supreme Court was there persuaded, as we had been, 176 F. 2d 152 (2 Cir. 1949), that references to convertible bonds in the legislative history precluded an interpretation excluding the portion of the purchase price paid for a conversion feature from the basis from which premium was computed. Congress responded by changing the statute almost immediately, Act of Sept. 23, 1950, c. 994, Title II, §217(a),

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[7] The 1956 ruling permits use of the "special" redemption price "if an actual notice of call at the 'special' redemption price on a specific or ascertainable date has been issued with respect to any particular bond or bonds, or portion thereof * * *"

64 Stat. 927, 941. To be sure, as is usual, the change was prospective only; but both the action of Congress and the legislative history[8] reaffirm the purpose to limit the deductions to cases where the amortization represented appropriate provision for prospective losses of capital that lie within the bounds of reasonable contemplation rather than, as claimed in *Korell* and here, to permit deductions where it does not.

Judgments affirmed.

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[8] "Section 125 was intended primarily to deal with the case where the premium was paid because the security bore a stated rate of interest higher than that prevailing in the current market for securities of a like risk and a similar life. Equity required the allowance of a deduction against ordinary income in cases of this sort." 81st Cong., 2d Sess., Sen. Rep. No. 2375, U. S. Code Congressional Service (1950) p. 3101.

APPENDIX D

Opinion of the District Court—Parnell

MEMORANDUM OF DECISION

58-1 U.S.T.C. para. 9881

MILLER, District Judge: These two actions, involving the same legal queston, were tried together for convenience. The *Parnell* case involves first mortgage bonds of the Appalachian Electric Power Company dated June 1, 1951, and purchased by plaintiff, Riley L. Parnell, on September 18, 1952, the tax year in question being 1952. The *Reed* case involves Georgia Power Company first mortgage bonds dated December 1, 1947, and purchased by plaintiff J. H. Reed, Jr., on October 29, 1954. The tax year involved is 1954.

In both cases the taxpayers in determing the amount of bond premium computed the difference between the purchase price of the bond and the lowest price at which the bond could be called on the earliest call date, such price being the "special call price", or "special redemption price". It is the insistence of the taxpayers that the method employed by them was clearly authorized by applicable statutes. It is the insistence of the defendant that the special call price provided for in the bonds in question was not "reasonable" within the meaning of the applicable statute and that the amount of bond premium should have been determined by the taxpayers with reference to the general call price provided for in the bonds.

Appendix D

Having considered the contentions of the respective parties as set forth in oral argument and exhaustive briefs, the Court is persuaded that the method employed by the taxpayers is authorized by the applicable statutes when construed in view of their wording and legislative history. Nor can the Court agree with the argument of the defendant that the "special call price was a mere sham and taxpayers' attempt to amortize their bonds with respect to such price was unreasonable". The Court is convinced that the special call price provided for in the bonds in question is altogether reasonable and realistic.

It would serve no useful purpose to extend this memorandum since detailed findings of fact and conclusions of law should be filed. Suggested findings and conclusions to implement this memorandum, together with a form of judgment, will be prepared by the plaintiffs and filed with the Court after first being submitted to the defendant for approval.

Findings and conclusions are reported at 187 F. Supp. 576 (M. D. Tenn. 1959